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VALUE ADDED TAX VERSUS BROADER INCOME BASE: TAX REFORM FOR THE RICH OR THE NOT SO RICH*

Charles I. Kingson†

I could easily add \$50-billion to the base through tax reforms

Joseph Pechman, explaining how Senator McGovern's negative income tax proposal (later abandoned) might be financed.¹

Glendower: I can call spirits from the vasty deep.

Hotspur: Why, so can I, or so can any man; But will they come when you do call them?

Shakespeare²

Our tax structure rests ultimately on belief in its fairness. The revelation that six hundred millionaires had avoided paying any federal income tax led Joseph Barr, then Undersecretary of the Treasury, to warn of a "taxpayers' revolt,"³ and prompted the Tax Reform Act of 1969.⁴ Similar indignation followed disclosures that the former French premier⁵ and Governor Ronald Reagan⁶ had avoided paying the income tax imposed by their own jurisdictions. To most people, fairness means progressive taxation—the richer you are, the greater your proportionate obligation to contribute to the public benefit.

In theory, then, progressive taxation should be politically popular;

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¹ N.Y. Times, June 28, 1972, at 65, col. 2.

² *Henry IV, Part I*, act III, scene 1.

³ NEWSWEEK, Jan. 27, 1969, at 79.

⁴ Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.) [hereinafter cited to respective sections of the Internal Revenue Code].

Stimulation of legislative action by public disclosure is not a new phenomenon. The present provisions taxing personal holding companies can be traced to the early years of the Depression, when—at a time when the financial community was calling for a spirit of sacrifice—it was discovered that people such as E.W. Scripps, Andrew Mellon, and Cecil B. DeMille were legally using such companies to escape individual tax on substantial income from stock investments. See P. STERN, *THE GREAT TREASURY RAID* 131-37 (1962).

⁵ See N.Y. Times, Feb. 3, 1972, at 14, col. 5.

⁶ See *id.*, May 5, 1971, at 53, col. 3.

in practice, the embodiment of progressivity in an income tax is anything but. First, the income tax is highly visible: a paycheck shows how much extra cash an employee would have if income tax did not have to be withheld,⁷ and the necessity of filing a return reminds everyone of exactly how much he had to pay. Second, the unrealistically high rates of tax (ranging up to ninety-one percent just a few years ago) in some cases—for example, athletes or overnight movie stars—turns progressivity into near confiscation. Third, the nominal progression indicated by the rates is illusory—as shown by the six hundred millionaires. The Nixon Administration recommended the recently completed study of a value-added tax (VAT),⁸ which would suffer none of those drawbacks: first, it would be included in the price of goods; second, its rate would be perhaps three percent; and third, it would apply uniformly, except—as indicated by HEW Secretary Elliot Richardson—for rebates to families with income of less than, say, \$12,000.⁹

If, however, the value-added tax is to raise an estimated \$13 to \$16 billion of revenue,¹⁰ some of us will have to pay something. This article attempts to suggest who will, and—with reference to several recent proposed changes in the income tax law—who should.

⁷ A California proprietor used to give his employees their gross salary in cash. They then filed past tables and handed over the various withholding taxes.

⁸ See N.Y. Times, Jan. 22, 1972, at 12, col. 3.

VAT is a tax imposed at each stage of the production process on the value added by the producer. To illustrate, assume the following transactions:

1. Farmer sells wheat to the miller for \$1.00.
2. Miller sells flour to the baker for \$2.00.
3. Baker sells bread to the grocer for \$3.00.
4. Grocer sells bread to the housewife for \$4.00.

If the VAT rate were 5%, the farmer would collect \$.05 of tax from the miller. The miller in turn would collect \$.10 from the baker; but owing to credit for the \$.05 he paid to the farmer, he would pay over to the government only \$.05. This represents the 5% tax rate as applied to the difference between the cost of his purchase and his gross sales—that is, the value added by him. The baker in turn would collect \$.15 from the grocer, and the grocer, \$.20 from the housewife. In the above sequence, the credit allowed to those purchasing for resale has two effects. First, the VAT must be separately stated to everyone except the housewife; she needs no records since she receives no refund. Second, if the housewife is willing to buy the bread for \$4.20, she has borne the entire tax.

Other types of VAT would allow credits, with respect to capital equipment purchases, only to the extent of depreciation, if at all. See Oakland, *The Theory of the Value-Added Tax: I, A Comparison of Tax Bases*, 20 NAT'L TAX J. 119, 122 (1967). See also, Oakland, *The Theory of the Value-Added Tax: II, Incidence Effects*, *id.* at 270. The type of VAT described, however, is that most likely to be considered for the United States. See Surrey, *Value-Added Tax: The Case Against*, 48 HARV. BUS. REV., Nov.-Dec. 1970, at 86, 87-88.

⁹ N.Y. Times, Feb. 11, 1972, at 35, col. 1.

¹⁰ See *id.*

I

PUBLIC ATTITUDES

Initially, let me explain some realities with which the enemies of progressive taxation are generally familiar.

A. *Revenue*

Progressive taxation cannot be justified solely on the basis of a need for revenue. Since the very rich constitute a small minority, the bulk of revenue must be raised from the middle and lower-middle income classes.¹¹ Thus, to the people for whom progressive taxation is most painful—and who by their political influence are most able to undermine it—its justification must rely on egalitarian ideas rather than practical needs.

B. *Progressivity*

Progressive taxation does not just mean that the rich pay more taxes than the poor, but that they pay *proportionately* more taxes. For example, a flat ten percent income tax rate means that a person with \$10,000 of income pays one-tenth as much tax as a man with \$100,000 of income; but that does not mean that the tax is progressive. The federal income tax rates indicate that we expect the \$10,000 man to pay a twenty-two percent tax on his next dollar of income, whereas the \$100,000 man will pay sixty percent. The proponents of VAT claim that rebates of tax to the poor will insure against its being regressive.¹² Even to debate in such terms accepts a basic and far-reaching attack on our idea of tax equity; we are asked to believe that a tax is acceptable so long as middle-income people do not pay proportionately more than the rich.¹³

¹¹ To illustrate, in 1969 the Treasury estimated that an increase in everyone's personal exemption from \$600 to \$1,000 would result in a \$12.7 billion revenue loss. 115 CONG. REC. 35,487 (1969) (statement of Senator Long).

¹² That man is poor who consumes all of his earnings. Rich is the man who consumes only a fraction. In Italy, for no clear reason, consumer goods are taxed to the last cent. But the income tax is a real joke.

I have been told that the economics textbooks call this system of taxation "painless." Painless means that the rich manage to have the poor pay the taxes without the poor noticing it.

THE SCHOOLBOYS OF BARBIANA, LETTER TO A TEACHER 62 (N. Rossi & T. Cole transl. 1970), quoted in Gordon, *Taxation of the Poor and the Normative Theory of Tax Incidence*, AM. ECON. REV., May 1972, at 319.

¹³ This idea was neatly summarized by Anatole France, who wrote that the law in its impartial majesty forbade the rich and the poor alike to beg and to sleep under bridges.

C. *Visibility*

A decision to impose VAT—the equivalent of a national sales tax—rather than to increase federal income tax collections reflects the popular attitude that if you don't see it, it doesn't cost anything. State legislatures, presented with a similar choice, almost always choose the less-resented sales tax. Public opinion forced Connecticut to repeal its income tax.¹⁴ New York City was willing to extend a sales tax of seven percent to meals costing less than a dollar—the “hot dog tax.”¹⁵ Shortly thereafter, the newspapers reported that about one-half the federal employees in the city failed to pay the city income tax.¹⁶ Thus, people who did not publicly demonstrate against a sales tax were willing to commit a crime rather than pay income tax. In New Jersey, Governor Cahill's progressive income tax was badly defeated.¹⁷ In New Hampshire, opposition to a state income tax is so entrenched that as a candidate in the 1972 presidential primary Representative Wilbur Mills, departing from the prepared text of his speech, retreated from his support of such a tax as a condition for revenue sharing.¹⁸ Had the tax on tea been sufficiently indirect, Massachusetts might still be a British colony.

The regressiveness of state sales taxes can be seen in the optional tables attached to the 1972 federal income tax forms. Those tables indicate that for each \$1,000 of additional income, two percent of the sales tax considered paid by a family with a \$20,000 income must be added. Thus, a family having \$40,000 of income—double that amount—is estimated to pay only two-fifths more sales tax. And state sales taxes are even more regressive than VAT, since they are deductible from federal taxable income. After giving effect to such deduction, state sales tax costs the \$40,000 family only thirteen percent more than it does the \$20,000 family.¹⁹

Local property taxes also fall more heavily on the poor.²⁰ But the personal attention of an individualized assessment, together with the

¹⁴ See generally *N.Y. Times*, July 9, 1971, at 1, col. 1; *id.*, July 25, 1971, at 1, col. 7; *id.*, Aug. 24, 1971, at 1, col. 4.

¹⁵ *Id.*, June 23, 1971, at 49, col. 2.

¹⁶ *Id.*, Dec. 20, 1971, at 26, col. 4.

¹⁷ *Id.*, July 18, 1972, at 1, col. 6.

¹⁸ *Id.*, Feb. 16, 1972, at 20, col. 2.

¹⁹ For married taxpayers, a deduction from \$40,000 of income saves 45% of the state tax; from \$20,000 of income, 32%. The net cost of \$100 sales tax to a \$20,000 family is \$68; of \$140 of tax to a \$40,000 family, \$77.

²⁰ The Governor's Tax Policy Committee in New Jersey recently reported that residents earning less than \$5,000 pay five times the effective property tax rate of those with an income of \$25,000 or more. *N.Y. Times*, Feb. 27, 1972, § 4, at 7, col. 2.

necessity for making out a large check, makes the act of giving painfully clear to the taxpayer. Suburbanites, rich and poor alike, resent the crushing property tax burden. In contrast, city tenants—who protest most other taxes—generally suffer property tax increases in silence. Ironically, such taxes hurt them more than suburban homeowners, since the property taxes they pay—in the form of increased rent—do not reduce their income taxes. The reason must be that since the monthly check is paid to the landlord, he, rather than the city, is blamed for any rent hike.

Perhaps the best examples of painless taxation are Off-Track Betting and state lotteries.²¹ Whether such state-sponsored gambling beneficially diverts funds of low-income people from bookies to public uses is beyond the scope of this article. The point is that there is little opposition to such regressive taxes from those who pay them.

In terms of invisibility, then, nongambling taxes can be ranked as follows: a sales tax has the lowest profile; local property taxes encounter strong resistance from homeowners, less from tenants; and everyone hates an income tax. Unfortunately, the ranking of these taxes also reflects their regressiveness. A sales tax falls on everyone, but less on those who can afford to save; a real property tax is imposed in proportion to the value of one's residence, but on the basis of gross value rather than unmortgaged ownership, and with an income tax disadvantage to those who cannot afford to be homeowners; and an income tax is imposed on the basis of income. The political appeal of the Nixon Administration's suggestion that VAT would reduce local property taxes was that the former is more palatable, whereas abating property taxes by increasing income tax rates would raise the same opposition at the federal level that it did in New Jersey.²² Moreover,

²¹ In comparing such devices with taxes, one observer noted:

The government takes the same amount of money from its citizens in both cases, though not necessarily from the same citizens. By running a lottery it avoids certain unwanted consequences: people escape from heavy taxation by moving away or they counterattack by throwing a government which imposes new taxes out of office. A lottery . . . has neither of these effects. The only opposition comes from those . . . who are themselves seldom gamblers.

B.F. SKINNER, *BEYOND FREEDOM AND DIGNITY* 38 (1971).

New Hampshire has perfected this quasi-taxing device to a fine art. The state raises a significant portion of its funds from gambling activities. Not only does that revenue come primarily from the poor, but in large part from the poor in Massachusetts and from tourists who visit New Hampshire to avoid the sales and excise taxes of other states. Although the state ranks low in services provided for its residents, they have vigorously resisted both an income and sales tax. The state's most influential newspaper, the *Manchester Union-Leader*, opposes both taxes. Its publisher, William Loeb, lives in Massachusetts.

²² Ironically, the Advisory Committee on Intergovernmental Relations recommended

VAT would be even less visible than a state sales tax, since it would be included in the price of goods. Thus, just as the tenant blames his landlord for passing on property taxes in the form of increased rent, the consumer would be likely to attribute higher VAT prices to the retailer.

D. *Bookkeeping and Good Causes*

Controversial and unpopular budget appropriations are often financed out of general tax revenues; no one would propose a napalm tax. Conversely, a specific regressive tax measure when linked to a popular cause can gain wide support, as in the case of the social security tax. Insistence that payments to the elderly appear to be the return of their own contributions permits one of the larger federal expenditures to be financed in great part by tax on only the first \$10,800 of income.²³ Although the recent increase in payroll taxes should collect more revenue than would VAT, its connection with increased social security benefits, which are felt to benefit the taxpayer or his family, allowed it to pass without significant opposition from either tax reformers or the general public.²⁴ However, since this money ultimately represents a claim on the federal government, the idea of funds in one or another government trust means nothing more than a choice between marks in a ledger.²⁵

against using VAT to reduce the property tax not on grounds of tax equity, but primarily on the theory that any federal financing of local education would carry with it the possibility of federal control. N.Y. Times, Dec. 15, 1972, at 1, col. 4.

²³ See INT. REV. CODE OF 1954, § 3121(a)(1), as amended, 85 Stat. 5 (1971) [hereinafter cited as CODE].

²⁴ An exception was a letter to the New York Times by Pechman, Rivlin, Schultze, and Teeters, among others, dated September 28, 1972. The letter pointed out that the proposed increase in the social security tax (later enacted) would extend its rapid growth from 12.6% of federal revenues in 1963 to 25% in 1973; that between 1965 and 1971 payroll taxes exceeded payment to beneficiaries by \$13 billion; and that the effective payroll tax on a worker earning \$9,000 or less in 1972 is 10.4%, but on a person earning \$50,000 is 1.9%. These percentages, however, reflected a stated premise that workers also bear the one-half of the tax collected from employers. The writers suggested that one effective method of reform would be to limit the payroll tax to pooled family earnings in excess of personal exemptions and a low income allowance, which amounts to \$4,300 for a family of four. N.Y. Times, Oct. 4, 1972, at 46, col. 3.

²⁵ The unreality of allocations is shown by the Revenue Act of 1971 (Pub. L. No. 92-178, 85 Stat. 497 [hereinafter cited to respective sections of the Internal Revenue Code]), which repealed the federal excise tax on cars. In order to provide a mechanism for continuing the present pace of highway construction rather than having to justify expenditures from general revenues, the Act allocated revenues from the alcohol tax to highway construction funds. Logically, such an allocation must rest on the assumption that people on the road are mostly drinkers.

The Soviet Union indulges in far worse political bookkeeping. In lieu of imposing

II

THE REVERSED POSITIONS

The strongest argument for VAT is its potential as a politically acceptable way of increasing federal revenues.²⁶ A three percent VAT could raise perhaps \$18 billion, of which \$3 to \$5 billion would be refunded to taxpayers with incomes of less than \$12,000. Opponents of VAT, however, feel not only that such a tax would impose a disproportionate burden on low- and middle-income groups, but also that these people already pay too great a share of total taxes. To remedy this, the income and corporate tax base would be broadened by reducing or eliminating tax preferences—those credits, deductions, and exclusions which do not reflect “costs incurred in the process of producing or earning” the taxpayer’s income.²⁷

Amazingly, however, each side has publicly adopted the other’s strongest argument—VAT is promoted in the name of fairness, and a broader income base is suggested as a fundraiser. Speaking for the Nixon Administration, John Ehrlichman has indicated that VAT would be used not as a revenue measure, but as a substitute for “unfair and regressive” state and local property taxes.²⁸ To urge VAT as a relief from regressive taxation is political *chutzpah*. First, the trend of recent court decisions is to decrease the proportionate property tax burden

taxes, the U.S.S.R. finances public expenditures—as the employer—by limiting the salaries of its citizens. This amounts to an invisible withholding tax. But its claim that emigrants should repay to the state the cost of their schooling (why not of their garbage collections?) in the form of a departure tax graduated according to degrees earned, assumes that the cost of education is borne by one of the following: (1) the people who stay; (2) the uneducated, which amounts to regressive taxation; or (3) no one. That allocation would not fool a 50-year-old New Jersey homeowner, who knows that his taxes have financed *someone’s* education.

²⁶ VAT has been defended as the “least bad” tax for this purpose. See Smith, *Value-Added Tax: The Case For*, 48 HARV. BUS. REV., Nov.-Dec. 1970, at 77. A Presidential Task Force qualified its rejection of the tax by recommending that in the event of an unexpected inadequacy in revenue “the Federal Government should turn to indirect taxation.” PRESIDENT’S TASK FORCE ON BUSINESS TAXATION, REPORT 70-71 (1970) [hereinafter cited as TASK FORCE REPORT]. The Task Force did not consider that the asserted VAT advantages of administrative convenience, neutrality among types of business organizations, and export competitiveness sufficiently warranted enacting it. *Id.* at 61-69.

²⁷ Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 724 (1970).

²⁸ N.Y. Times, May 26, 1972, at 1, col. 2. Ehrlichman was responding to a study by the Brookings Institution which concluded that the government could not spend more on social problems without a substantial tax increase. See C. SCHULTZE, E. FRIED, A. RIVLIN & N. TEETERS, SETTING NATIONAL PRIORITIES: THE 1973 BUDGET 421-22 (1972) [hereinafter cited as BROOKINGS STUDY]. See also *id.* at 394-448.

of lower-income communities.²⁹ Second, a tax on consumption, before modification by exemptions for items such as food and medicine, may well be borne in almost inverse proportion to the value of property owned.³⁰

Even with a rebate to persons whose incomes are below a certain level, the tax continues to have several regressive features. Initially, regressiveness begins above the last rebate level. Furthermore, since VAT is not separately stated, nonrefundable local sales taxes would be imposed on the increased price passed on to the consumer—a tax upon a tax. Moreover, assuming a yearly rebate of \$4 billion, the government will have the equivalent of an annual \$2 billion interest free loan. The Revenue Act of 1971 enacted the asset depreciation range system (ADR),³¹ which permits equipment to be depreciated at an artificially fast rate for tax purposes. This grants business the interest free use of about \$2 billion. To use one bookkeeping method, therefore, VAT and ADR taken together result in a semi-permanent \$2 billion interest free loan to business from the poor.³²

Even assuming that a sales tax can be structured to be less regressive than a property tax, to say that VAT substitutes for other taxes rather than raises revenues is political bookkeeping. With VAT the federal government will have, say, an extra \$13 billion to spend. Its use of a corresponding \$13 billion to subsidize local public education does not mean that VAT collections differ from other tax collections reflected in the government budget, but only that the public will associate the two.

Instead of emphasizing its fairness and progressiveness, however, proponents of a broader income base have too often justified it by asserting the need for more social spending. The case for a more

²⁹ Recent court decisions, notably *Serrano v. Priest*, 5 Cal. 3d 584, 487 P.2d 1241, 96 Cal. Rptr. 601 (1971), and *Robinson v. Cahill*, 119 N.J. Super. 40, 289 A.2d 569 (1972), have mandated similar per-pupil educational expenditures on a statewide basis. In New Jersey, for example, this will result in a lower percentage property tax assessment in poorer communities and a higher percentage in rich ones. Use of the VAT to subsidize local education could neutralize this step towards progressiveness.

³⁰ According to fairly recent statistics, 2% of the population gets more than 40% of the corporate dividends, but accounts for less than 6% of consumer expenditures. U.S. BUREAU OF LABOR STATISTICS, SURVEY OF CONSUMER EXPENDITURES: 1960-61, at 27 (1966).

³¹ CODE § 167(m), as amended, 85 Stat. 497 (1971).

³² VAT could, however, reduce property taxes even for those to whom it is refunded. If lower property taxes resulting from VAT must be passed on by landlords in the form of lower rents, the income tax inequity between homeowners and tenants would be reduced. This inequity particularly discriminates against middle-income people, since those apartment dwellers with capital can obtain the deduction for property taxes (and also mortgage interest) by purchasing stock in a cooperative building. *Id.* § 216.

equitable system does not depend upon the need for additional revenue; linking the two allows VAT's critics to pose the issue as one of political realism—"a limit to the willingness of the nonpoor to give income to the poor."³³ As one salesman put it, "I don't want them to redistribute my income."³⁴

The tax program outlined during Senator McGovern's presidential campaign attempted to dispel this reaction in two ways: first, by choosing reform proposals which enabled him to say that no one whose income was exclusively wages would pay one cent more in taxes; and second, by linking reform revenues to such noncontroversial issues as cleaner air, better education, and property tax relief.³⁵ But the Republican response to McGovern's call for tax reform—a pledge not to seek a rise in taxes—indicated a belief that this reaction persists. In describing the pledge, John Ehrlichman declined to characterize VAT as either a tax reform or a tax increase, calling it a "substitution" of one form of taxation for another.³⁶

But substitution is exactly how tax reform, which means reallocating the relative burden *among* taxpayers, differs from the issue of

³³ Herbert Stein, Chairman of the President's Council of Economic Advisers, so criticized Senator McGovern's early fiscal proposals. *N.Y. Times*, June 18, 1972, at 1, col. 3. Those proposals included the suggestion that reform "could go a long way toward financing the Minimum Income Grant program" of \$1,000 per person. G. McGovern, *Tax Reform and Redistribution of Income*, Jan. 13, 1972 (press release) (on file at the *Cornell Law Review*).

³⁴ *N.Y. Times*, Sept. 10, 1972, § 4, at 6, col. 4.

³⁵ *Id.*, Aug. 30, 1972, at 22, col. 4.

³⁶ *Id.*, Sept. 8, 1972, at 1, col. 5. Ehrlichman was even willing to back off from property tax relief as a short-term goal, indicating that such relief might eventually be financed without resort to additional taxes, even VAT.

President Nixon subsequently referred to "one problem" with his commitment to no tax increase, although he limited that commitment to 1973: "There will be no Presidential tax increase. . . . [T]here could be a Congressional tax increase. If the Congress, for example, does not approve the \$250-billion ceiling [on spending] that we have requested, that is going to make the chances of avoiding a tax increase more difficult." Official transcript of President Nixon's news conference, Oct. 5, 1972, *reported in id.*, Oct. 6, 1972, at 28, col. 4. After defeat of the spending ceiling, however, the President vetoed a water pollution bill, stating: "As with the spending ceiling, so with this bill, a vote to sustain the veto is a vote against a tax increase. A vote to override the veto is a vote to increase the likelihood of higher taxes." *Id.*, Oct. 19, 1972, at 28, col. 3. But popular direct grants, like clean water and social security, politically outweigh the prospect of higher taxes. Even Gerald R. Ford, the House Republican leader, voted to override the veto. *Id.*

Despite this pledge, on October 30, 1972, President Nixon signed into law a bill (Act of Oct. 30, 1972, Pub. L. No. 92-603, 86 Stat. 1329) increasing the social security tax rate on both employers and employees by 12.5%, or some \$4.5 billion per year. This bill, together with the 1972 expansion of the contribution base (*see* Act of July 1, 1972, Pub. L. No. 92-336, 86 Stat. 405) will raise the maximum social security contribution from \$468 per year in 1972 to \$702 in 1974—a 50% increase. *N.Y. Times*, Oct. 31, 1972, at 1, col. 6.

whether, owing to federal spending, the *total* national tax burden should increase. A \$13 billion VAT would constitute just as fundamental a tax reform as would redistributing an equivalent amount through income tax amendment.³⁷ The difference between the two reforms conceals a fundamental disagreement as to who should pay. A broader tax base would shift part of the income tax to those who enjoy benefits such as the exclusion from income of one-half of long-term capital gains;³⁸ VAT would fall disproportionately on those who cannot afford to invest in capital assets.

Unfortunately, however, the choice between the two types of reform may be distorted into one between higher income tax and spending on the one hand, and VAT and lower property taxes on the other. The property tax, according to Mayor John Lindsay of New York City, is the most hated tax,³⁹ yet in New Jersey, blue collar neighborhoods opposed an income tax primarily designed to relieve them from a property tax.⁴⁰ If an equitable state income tax is resisted even when the taxpayer visibly benefits, the linking of a broader federal base to spending on others will provoke even greater opposition.

III

TAX AND BUDGETARY EXPENDITURES

It is more difficult to identify the beneficiaries of tax expenditures than the recipients of direct budgetary grants. But when the specific results of tax subsidies become apparent, public indignation will often override generalized agreement with their objectives. For example, there is widespread agreement that charity should be privately supported and that double taxation should be minimized. The fact that the charitable deduction could excuse several millionaires from income tax, however, helped lead to the Tax Reform Act of 1969.⁴¹

³⁷ The income and corporate reforms proposed by the *Brookings Study* would raise a comparable \$13.4 billion. BROOKINGS STUDY 434. Senator McGovern's campaign proposals suggested an increase of about \$22 billion. N.Y. Times, Aug. 30, 1972, at 22, col. 4.

³⁸ CODE § 1202.

³⁹ See Logan, *Around City Hall*, THE NEW YORKER, June 10, 1972, at 112.

⁴⁰ N.Y. Times, June 18, 1972, § 4, at 5, col. 3.

⁴¹ The provision in question permitted individuals who had contributed large amounts to charity for several years to deduct their charitable contributions without limit. Abuse of the provision was not in the amount but in the form of the contribution, generally highly appreciated securities. For example, the contribution of \$100 in appreciation by a taxpayer in the 70% bracket now costs a taxpayer \$30, whereas its sale at capital gains rates could cost him up to \$35. Thus, in some instances it is cheaper to give property to

Regardless of whether few or many people benefit from a specific tax expenditure, deductions for some must be paid for by others. For this reason I consistently fail to enjoy tales of my friends' ingenuity—the broker who deducts dinner with his brother; the lawyer who purportedly sets aside part of his living room to read cases; and the newsman who takes depreciation on his television set. They are not only fooling an abstraction called the government, they are fooling me.⁴²

One explanation advanced for such behavior by people who do not rush to tell me of the doubtful legality of their activities in other areas is that everybody does it. This is not true. Everybody does *not* do it, the majority out of conviction and others because they are not afforded the opportunity. Furthermore, the consequence of such an assumption, if widely acted upon, is not less taxation but more regressive taxation.⁴³

Tax expenditures are not, therefore, just neutral economic incentives; they cost as much as budgetary expenditures.

Most economists would define that \$5.7 billion [in income taxes saved owner occupants during fiscal 1971 through deduction of mortgage interest and property taxes] as a subsidy, just as they would the approximately \$3 billion of public funds that goes to pay rent (mostly on slum dwellings) for welfare recipients.⁴⁴

The tax subsidy for people with capital gains has been estimated, at

charity than to sell it; in these cases the government rather than the taxpayer is the real donor.

The 1969 Act phased out the unlimited deduction for charitable contributions. The more significant preference, contribution of appreciated capital assets, remained, owing in part to pressure from universities. If named after their real contributors, many new dorms could be called Taxpayer Hall.

France has mitigated double taxation of corporate profits by giving shareholders credit for corporate tax paid with respect to earnings distributed as dividends. The same treatment has recently been extended to American shareholders of French corporations. Yet when, according to newspaper stories, the credit entirely offset the income tax liability of former Premier Chaban-Delmas, he felt compelled to explain the situation on television. *See id.*, Feb. 3, 1972, at 14, col. 3.

⁴² Similarly, to the extent that high bracket taxpayers are offered disproportionate tax benefits for investing in low-income housing or municipal bonds, it is the taxpayers who do *not* so invest, and must therefore make up the lost tax revenues, that actually bear the subsidy.

⁴³ For example, despite its reputation as a country of tax evaders, France recently imposed taxes equal to nearly 42.5% of its gross national product, as compared to about 32.9% in the United States. Moreover, 35% of the 42.5% in France was collected in the form of sales and social security taxes; in the United States the figure was just 15.8%. As a corollary, the United States collected nearly twice the French percentage in individual income taxes. Calkins *et al.*, *Should the United States Adopt the Value-Added Tax?—A Survey of the Policy Considerations and the Data Base*, 26 *TAX LAWYER* 45, 46 (1972).

⁴⁴ Breckenfeld, *Housing Subsidies Are a Grand Delusion*, *FORTUNE*, Feb. 1972, at 166.

1972 income levels, to be about \$13.7 billion, of which almost \$12 billion goes to people with income of more than \$25,000.⁴⁵

Pointing out that some taxpayers subsidize others does not necessarily mean that the practice should cease, but it does suggest two conclusions:

1. *Recognition.* If tax subsidies can be clearly recognized, they will be subject to the same scrutiny as direct expenditures. Section 1240 of the Internal Revenue Code was enacted and limited so as to benefit one person, Louis B. Mayer.⁴⁶ It would be difficult to conceive of Congress passing a bill which made a special cash grant to Mr. Mayer. In an attempt to equate tax subsidies and direct expenditures in the public mind, the 1968 annual report of the Secretary of the Treasury included a "tax expenditure budget," that is, a list of foregone tax revenues in categories similar to those of the actual budget.⁴⁷ So far, however, the effort to increase visibility of the tax expenditure budget has been largely restricted to law review articles.⁴⁸ The political disparity between tax and direct expenditures can be seen by comparing the widespread criticism of Senator McGovern's proposal to increase everyone's taxable income by \$1,000 through a cash grant⁴⁹ with the broad-based public support of the 1969 proposal to exempt \$1,000 of everyone's income from tax by an increase in the personal exemption.

Interestingly, the Nixon Administration's equation of tax and

⁴⁵ Pechman & Okner, *Individual Income Tax Erosion by Income Tax Classes*, in U.S. CONG. JOINT ECON. COMM., THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS: A COMPENDIUM OF PAPERS pt. 1, at 34 (1972). Treasury figures indicate that the capital gains subsidy, not including taxing capital gains at death, is \$5.6 billion, of which nearly \$3 billion goes to taxpayers with an adjusted gross income of at least \$100,000. Statement of Treasury Secretary Cohen at Hearings on Tax Subsidies and Tax Reform Before the U.S. Cong. Joint Econ. Comm., 92d Cong., 2d Sess., reprinted in BNA DAILY EXECUTIVE REP., No. 142, July 21, 1972, at J-9. Senator McGovern's advisers estimated that taxing capital gains as ordinary income at a maximum rate of 48% would raise \$7 billion from individuals annually. N.Y. Times, Aug. 30, 1972, at 23, col. 7.

⁴⁶ Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1147 n.4 (1957).

⁴⁷ U.S. TREAS. DEP'T, 1968 ANNUAL REPORT OF THE SECRETARY OF THE TREASURY 326 (1969). For example, the deduction for property taxes was classified as an expenditure for community development and housing. *Id.* at 334.

⁴⁸ See, e.g., Surrey, *supra* note 27.

In 1971 the Senate passed a bill requiring, *inter alia*, that the budget submitted by the President label and estimate the expenditures made through operation of the tax laws. That provision was deleted by a Senate-House conference committee on the ground that it would be "more appropriate" to have the information submitted to congressional committees. See CONF. REP. NO. 553, 92d Cong., 2d Sess. 49 (1971).

⁴⁹ See N.Y. Times, June 18, 1972, at 2, col. 3 (remarks of H. Stein, Chairman, President's Council of Economic Advisers).

budgetary expenditures led not to the conclusion that tax subsidies should be repealed, but to the conclusion that direct grants should be terminated. John Ehrlichman linked tax reform to repeal of such "no payout" programs as Model Cities.⁵⁰ But among the least productive programs we have are many tax subsidies. A consistent conservative position would be to make the continuance of such expenditures depend upon their social "payout."

2. *Substitution of Direct Grants.* Once it is determined that a subsidy is desirable, the question remains as to whether it should be effected through the tax code. Tax law does not necessarily avoid bureaucracy. For example, the provision for rapid amortization of water pollution control facilities requires certification by both the Secretary of the Interior and the appropriate state authority.⁵¹ The installer of such a facility could as easily receive his grant from the Secretary of the Interior as from the Internal Revenue Service.⁵² Direct subsidies have several distinct advantages over those granted by the tax code: they are subject to annual review, their amount can be controlled, and the same activity is benefited equally, regardless of who does it.⁵³ Most important, direct grants can be considered as part of an overall legislative program. The urban affairs committees in Congress could certainly make more informed judgments than the tax committees as to where, how, and if \$330 million a year should be spent to subsidize rehabilitation of low-income housing. Yet one of the more than fifty separate provisions in the Tax Reform Act of 1969, Code section 167(k), granted that subsidy by permitting rapid amortization of rehabilitation expenditures. The Senate Committee on Housing would not be considered sufficiently expert in tax law to accomplish Model Cities legislation by amending the Internal Revenue Code; thus, it is somewhat surprising that the Senate Finance Committee, with a comparable lack of knowledge as to housing needs, can enact its own Model Cities program through a tax expenditure.⁵⁴

⁵⁰ *Id.*, May 26, 1972, at 1, col. 2.

⁵¹ CODE § 169(d), added by 83 Stat. 667 (1969).

⁵² See Surrey, *supra* note 27, at 717.

⁵³ Under the present system a taxpayer in the 70% bracket receives a \$19 benefit for installing \$100 of pollution control facilities, whereas one in the 20% bracket gets the equivalent of \$5.00.

⁵⁴ See generally Surrey, *supra* note 27, at 715-26. The similarity also suggests that repeal of the Model Cities program, as proposed by Ehrlichman (see note 50 and accompanying text *supra*), should be accompanied by termination of the tax subsidy.

IV

RECENT PROPOSALS

The present clamor for tax reform, like the 1969 clamor, can be characterized by Samuel Johnson's statement that levelers want to level down to themselves, not up. The expanded tax base proposed by Pechman and Okner would produce more than \$77 billion of additional revenue at 1972 tax rates.⁵⁵ Nearly \$58 billion of that amount, however, comes from eliminating four items: (1) the advantages of income splitting for married taxpayers; (2) the favorable treatment of capital gains; (3) the preferences for homeowners; and (4) the non-taxability of such "transfer payments" as social security, railroad retirement benefits, and workmen's compensation.

The Pechman and Okner proposal would affect practically everyone. More than one-half of the homeowner preferences accrue to families in the \$10,000-\$25,000 income range; about forty percent of the capital gains benefit goes to those between \$15,000 and \$50,000; transfer payments are primarily made to the needy; and most taxpayers are married.⁵⁶ But politically it is hard to explain that many of these preferences are of greater *relative* benefit to upper-income groups. The carrot in the Pechman and Okner proposal is cutting tax rates by an average of forty-three percent.⁵⁷ Under their rate schedule—from seven percent to a top marginal rate of forty-four percent—average tax payments would decrease for all families with incomes below \$25,000, and the maximum average percentage increase in tax liability—for families with incomes of over \$1 million—would be twenty-six percent.⁵⁸

In addition, certain aspects of a theoretically equitable tax base lend themselves to political ridicule. Among the homeowner preferences included in the Pechman and Okner expanded income base is the rental value of owner-occupied homes. If tax reform proposals are characterized as making you pay yourself rent, the entire idea loses credibility. As Representative Wilbur Mills remarked: "[F]ew of us are likely to be persuaded by the proposals sometimes made in academic quarters to tax homeowners on [imputed rental value], even though it may constitute a substantial portion of their personal income."⁵⁹ The

⁵⁵ Pechman & Okner, *supra* note 45, at 23.

⁵⁶ *Id.* at 22-40.

⁵⁷ *Id.* at 29.

⁵⁸ *Id.* at 31-32.

⁵⁹ Address by Representative Wilbur Mills, Securities Industry Ass'n Management Conference, Washington, D.C., Sept. 8, 1972.

Pechman and Okner proposal is, of course, not intended for use as a campaign tract; however, tax reform, like salvation in *Major Barbara*, will not come until the professors of Greek learn to make gunpowder.

The procedural and political frustrations connected with broadening the tax base are illustrated by the Tax Policy Review Bill of 1972,⁶⁰ introduced in May 1972 by Representative Wilbur Mills and endorsed by the Democratic presidential campaign platform. The bill set termination dates in 1974, 1975, and 1976 for fifty-four tax preferences, eighteen of which were to be repealed each year. Commenting on the bill, Mills stated that many preferences were still desirable, and that threatened expiration would force public review of the merits of all.⁶¹ The list of preferences included such major items as the favorable treatment of capital gains, deductions for nonbusiness interest and taxes, accelerated depreciation, the investment credit, and ADR.

In the absence of a tax expenditure budget, it is unlikely that Congress would have considered the Review Bill provisions in comparison with direct grants for the same purpose. Treasury comment on the bill, echoing Ehrlichman,⁶² did just that, stating that "this proposed procedure should not in any way be the excuse for additional Federal spending. Indeed, we badly need a parallel, systematic and careful review that will end spending programs which have outlived their usefulness or are otherwise of questionable value."⁶³ The premise of this statement, however, is that new direct subsidies would need more justification than those now given by the tax code.

A more remediable defect of the Review Bill was its failure to consider tax provisions in context. For example, the scheduled termination dates of ADR, accelerated depreciation, and investment credit were each in a different year. Yet each is intended as an incentive to capital investment, and the basic question should be whether all three are necessary.

A second error was that the first two items to be considered related to strengthening the minimum tax. This is a ten percent tax, enacted by the Tax Reform Act of 1969 in response to disclosure of the non-taxpaying millionaires, on the amount by which a person's "tax preferences" exceed the sum of \$30,000 plus his federal taxes for the year.⁶⁴

⁶⁰ H.R. 15230, 92d Cong., 2d Sess. (1972) [hereinafter cited as Review Bill].

⁶¹ N.Y. Times, June 1, 1972, at 1, col. 1.

⁶² See notes 28, 50 and accompanying text *supra*.

⁶³ Treas. Dep't Release, May 31, 1972, reprinted in 1972 CCH FED. TAX REP., No. 31, June 7, 1972, at viii.

⁶⁴ CODE § 56, added by 83 Stat. 580 (1969), as amended, 84 Stat. 1846 (1970). The provision, as amended, allows a carryover of certain federal taxes paid in prior years.

The three most common tax preferences of individuals are the capital gains deduction,⁶⁵ qualified stock options,⁶⁶ and accelerated depreciation.⁶⁷ Each of these preferences confers a different degree of benefit. The capital gains deduction, for example, represents a complete exclusion from tax, whereas accelerated depreciation only defers taxation. Qualified stock options are not preferences at all, if preferences are defined as tax expenditures. Revenue loss by reason of the employee's escaping tax is usually more than offset by disallowance of a corresponding deduction to the employer.⁶⁸

Owing to the disparity in benefit among included preferences, the minimum tax is an abortion. Only the low rate and large base—that is, permitted preferences of \$30,000 plus income taxes paid—raise it to the level of a mistake.⁶⁹ Tax incentives and tax equity are antithetical;

⁶⁵ One-half of long-term capital gains, such as the gain on stock held for more than six months, is deductible and thus excluded from income. CODE §§ 1202, 1222(3). The excluded amount is an item of tax preference.

⁶⁶ The bargain element in a qualified stock option—basically an option granted to purchase the employer's stock at a price equal to its value on the date of grant—is a preference. For example, if an employee is granted a qualified option in 1970 to purchase stock at \$100—its then value—and exercises the option in 1972 when the stock is selling for \$120, the \$20 bargain is a preference. The \$20 profit is otherwise excluded from income until the employee disposes of the stock; if he holds the stock for three years, the \$20 is taxed as long-term capital gain rather than salary. See CODE §§ 421(b), 422(a)(1). The \$10 of capital gain excluded from income is again a preference, resulting in \$30 of preference on \$20 of profit. If it is not considered salary, however, the employer cannot deduct the \$20 as a business expense. Assume that both the employer and employee are in the 50% bracket. If the option in the above example were not qualified, upon exercise the employee would include in income \$20 and pay \$10 of tax; the employer would deduct \$20 and save \$10, resulting in no net revenue to the Treasury. When the employee pays a capital gains tax of, for example, \$5 by reason of having a qualified option, the employer does not get the deduction, and the revenue is ahead by \$5. A significant motivation for the use of qualified stock options is not tax advantage, but accounting rules. Often, classification of the \$20 bargain as salary for tax purposes will parallel its accounting treatment. Thus, the bargain element in an ordinary option will, by increasing salary expense, reduce corporate earnings. The same bargain in a qualified stock option may not, and companies generally prefer a better earnings statement to a tax deduction.

⁶⁷ The amount by which deductions for accelerated depreciation exceed those available under a straight line method is a preference item. For example, the yearly deduction for depreciation on a machine costing \$100 with a useful life of ten years would be \$10. Under one accelerated depreciation method, the first deduction would be about \$18. In the first year, therefore, taxable income is \$8 less than it would otherwise be, and the \$8 is a preference. On the other hand, under the accelerated method the depreciation deduction in the tenth year would be only \$2, or \$8 less than under the straight line method. Thus, the \$8 has not been excluded from taxable income, but deferred to a later year. Accelerated depreciation on personal property, however, is a preference item only when the property is subject to a net lease. CODE § 57(a)(3), added by 83 Stat. 581 (1969).

⁶⁸ See note 66 and accompanying text *supra*.

⁶⁹ Some of the *Brookings Study* suggestions include adding new preferences, raising the rate, and eliminating the base. BROOKINGS STUDY 433.

the justification for an economic incentive should not depend upon whom it motivates. It may be inequitable to give people in higher brackets a greater subsidy for installing the same amount of pollution control expenditures.⁷⁰ It is equally unfair to deny—through the minimum tax—twice the subsidy for twice the investment. If the government can forego \$200 in taxes to encourage the installation of \$1,000 of pollution control facilities, the question of whether the \$200 is saved by one or one hundred people is one of politics rather than equity. Fairness applies to the rich, too.

The minimum tax constitutes an admission that our tax expenditures are out of control, and strengthening instead of repealing it should be considered only after failure to control the preferences which it contains. Unfortunately, the Review Bill apparently would consider the minimum tax base before making a decision on the accelerated depreciation and capital gains preferences.

H.R. 15360⁷¹ would require review of the same fifty-four items as the Review Bill, but without automatic termination provisions.⁷² Procedurally, this raises the possibility of examining similar incentives as a group since the subsidies need not be considered in any particular order. Politically, however, it puts inertia on the side of the subsidized; it is easier to protest against eliminating a provision than to justify retaining it. This can be particularly significant when—as the bill requires—at least twenty-seven provisions will be examined each year.

Those who lose tax privileges see clearly what is happening, whereas, absent wholesale reform and a drastic rate reduction, repeal of any one provision may not seem of much general benefit. If the six hundred millionaires had paid all their income tax, it would not have appreciably lowered anyone else's. Reinforcing this legislative attitude is the system of campaign contributions. Substantial contributors may be liberal or conservative, on one side or the other of specific issues. They do, however, share one common attribute—money. Although reform of congressional campaign financing has not often been coupled with tax reform, it is doubtful that a legislator would support tax legislation—such as increased capital gains and estate taxes—aimed at the very people who underwrite his campaign expenses.

Effective tax reform seems to arise not from a review of the

⁷⁰ See note 52 and accompanying text *supra*.

⁷¹ 92d Cong., 2d Sess. (1972). The bill was introduced on June 7, 1972, by Representative Ullman of Oregon.

⁷² Primarily because of this difference, Representative Wilbur Mills called the bill "preferable" to his own measure. Address, *supra* note 59.

inequities of present law, but rather in response to a specific tax policy theme put forth by politicians. In 1969 it was the millionaires. As a presidential candidate, Senator McGovern's theme was "[m]oney made by money should be taxed at the same rate as money made by men."⁷³ He therefore proposed that capital gains be taxed as ordinary income (with a maximum tax rate of forty-eight percent), and that tax benefits for ownership interests in oil and gas, real estate, machinery and equipment, municipal bonds, overseas facilities, and export-related property be eliminated or reduced. Interestingly, the provisions he attacked can be defended as investment incentives. He refrained from criticizing most of those which cannot, such as the deduction for nonbusiness taxes or for charitable contributions of appreciated property. Although the latter do not discriminate against wage earners, their omission more probably resulted from the judgment of McGovern's advisers that, as Paul A. Samuelson commented,

[T]rying to close all loopholes—including . . . deductibility of interest on home mortgages . . . represents political suicide. You just cannot explain to people convincingly, even though it is true, that they will be better off if we are able to lower tax rates by closing up all such loopholes.⁷⁴

Business incentives, unlike personal deductions, can be defended in terms of their benefit to the economy, and limiting reform proposals to those provisions makes the issue one of need for the subsidy rather than whether it belongs in the tax code. Moreover, if tax reform does not bring lower rates, the most appeal it can offer is not to hurt the taxpayer.⁷⁵

V

DETERMINING WHO SHOULD PAY

Tax reform and additional federal spending should be independent issues,⁷⁶ particularly when such spending is associated with assistance to the welfare poor. A broader tax base affects relative burdens only among taxpayers, that is, those with income above the poverty

⁷³ N.Y. Times, Aug. 30, 1972, at 22, col. 2.

⁷⁴ *Id.*, Sept. 8, 1972, at 33, col. 2.

⁷⁵ McGovern's proposals would only benefit (by an estimated \$1.4 billion) persons with ordinary investment income now taxed at marginal rates of more than 48%.

⁷⁶ The tax expenditure concept is a way to evaluate existing spending programs rather than to suggest programs for which new taxes need be raised.

line.⁷⁷ VAT is intended to assure that new taxes will be borne by consumers in general rather than by investors; such changes as higher capital gains rates, termination of the investment credit, and repeal of ADR assume that investors do not bear enough of the present burden.

Politically, both sides overstate their case. The VAT rebate does not completely cure the problem of regressiveness; however, many economists believe that to some degree corporate taxes, as well as VAT, are passed on to consumers through higher prices. The Treasury estimates that if only one-fourth of the 1971 corporate tax collection was passed on to consumers, persons with incomes of less than \$15,000 would bear—both as consumers and shareholders—more than forty percent.⁷⁸

Any determination as to who should pay additional taxes should start by excluding unrealistic possibilities. The decision will not be made with reference to direct spending programs, despite the attempt to popularize the tax expenditure budget. Next, the employee portion of social security benefits will continue to be financed largely by a payroll tax. Moreover, even a reform-minded Congress is not likely to consider that equity or politics compels ending the income-splitting preference for married taxpayers, taxing homeowners on the imputed rental value of their homes, or treating social security benefits as income.

The question of tax reform thus becomes one of asking, within the above limits, whether capital, that is, people with capital, bear too little or too much of the present tax burden. The answer should take into account all major taxes—corporate and individual income, payroll, and estate and gift—not just income, as in the Review Bill.⁷⁹ If people with capital are bearing too much, then VAT is the best way to raise additional revenue; if these people are bearing too little, then the balance should be redressed through income and estate taxes.⁸⁰

⁷⁷ But see Dodyk, *The Tax Reform Act of 1969 and the Poor*, 71 COLUM. L. REV. 758, 786-87 (1971).

⁷⁸ See Statement of Treasury Secretary Cohen, *supra* note 45, at J-15 (Appendix F). The Appendix sets forth five different calculations of the amount of corporate tax borne by individuals of different income classes, depending on how much is shifted forward to consumers. The more tax shifted forward, the more borne by low- and middle-income people.

⁷⁹ Cf. notes 60-63 and accompanying text *supra*.

⁸⁰ It is interesting to compare the unexpressed balancing of earnings and capital under proposed income tax reforms. The *Brookings Study* would repeal the 50% maximum on earned income, while keeping ADR and the investment credit. BROOKINGS STUDY 432. The Review Bill would re-examine the latter two, but not the maximum tax. A proposed Tax Reform Act, introduced in March 1972 by Senators Hart, Keenedy, Mondale, and Nelson, would knock out all three. See S. 3378, 92d Cong., 2d Sess. (1972).

VI

THE PRESENT BALANCE

According to Assistant Secretary of the Treasury Frederick Hickman, estimated tax receipts for fiscal 1973 fall into the following categories:⁸¹

Tax	Amount (in billions)
Individual income	\$93.9
Corporate income	35.7
Social security (employer pays one-half and can deduct it from income tax)	63.7
Estate and gift	4.3

The employee portion of social security, even before the recent increases,⁸² amounts to about one-fourth of all taxes imposed on individual incomes.⁸³ The other three-fourths favors income from capital over income from services in several ways: investment credit, accelerated depreciation, ADR, capital gains preferences, and exclusions for interest on life insurance proceeds as well as for the first \$100 of dividend income. On the other hand, the maximum rate for earned income is fifty percent,⁸⁴ as against seventy percent for other income;⁸⁵ however, this generally benefits only taxpayers with annual earnings of more than \$52,000.

Using the tax collection figures, Secretary Hickman rebuts the idea that capital is unduly favored (and that we therefore need changes of the sort proposed by Pechman and Okner, and later in a modified form by McGovern) with three main statistical arguments.⁸⁶

First, without the legislation passed during the Nixon Administration, tax collections from individuals would be significantly higher. The greatest percentage reduction in tax, owing to the low-income allowance, has accrued to people with less than \$3,000 of income. Secretary Cohen testified that changes in the tax law since January 1,

⁸¹ Lecture on "Loopholes' and the Tax Base," by Frederick Hickman, Assistant Secretary of the Treasury, before the Ass'n of the Bar of the City of New York, in New York City, May 1, 1972. Figures for excise tax collections are omitted. This table fails to take into account the increased collections resulting from the two recent increases in the social security tax.

⁸² See note 36 *supra*.

⁸³ Individual income and employee social security collections total \$120 billion, of which \$30 billion is attributable to employee social security payments.

⁸⁴ CODE § 1348.

⁸⁵ CODE § 1.

⁸⁶ See Hickman, *supra* note 81.

1969, would, for the years 1969-1972, increase corporate taxes by \$4.9 billion, decrease individual income taxes by \$18.9 billion, and decrease excise taxes on cars and telephones—mostly benefiting individuals—by \$3.5 billion.⁸⁷

Second, most of the preferences cited by Pechman and Okner—notably, transfer payments such as social security—accrue to low-income taxpayers.

Third, since 1952 the effective income tax rate on individuals has remained constant at about ten percent, and the effective corporate tax rate, after allowance for investment credit and percentage depletion, is greater than in 1965.⁸⁸ Moreover, the effective federal income tax rate on individuals is progressive. Those with incomes of between \$10,000 and \$15,000 pay nineteen percent; on incomes above \$50,000, the effective rate is nearly forty percent.

Hickman's first point is correct. Several significant provisions of the Tax Reform Act of 1969, including increases in the personal exemption,⁸⁹ the standard deduction, and the low-income allowance, primarily benefited low-income taxpayers. On the other hand, the low-income allowance was predicated on a need for about \$1.50 a day to cover all nonfood expenses (at 1966 prices);⁹⁰ the Reform Act of 1969 reduced the average tax burden on the poor—combined federal, state, and local—from twenty-eight percent of income to twenty-six percent.⁹¹ Increases in the other deductions did not entirely offset the amount by which inflation had previously reduced their value. A family of four in 1948 would shelter proportionately more of its income with \$2,400 of personal exemptions than one with the same purchasing power in 1972, with \$3,000 of personal exemptions.⁹²

⁸⁷ Statement of Treasury Secretary Cohen, *supra* note 45, at J-2.

⁸⁸ *Id.* The figures, however, exclude ADR, which was enacted in 1971.

⁸⁹ The argument that personal exemptions should be abolished because they are worth more to high-income taxpayers, although frequently advanced, is not wholly persuasive. Admittedly, a \$750 exemption is worth more to a taxpayer in the 60% bracket than to one whose marginal rate is 20%. Most of the revenue, however, benefits low-income taxpayers. To a man earning \$100,000 an extra \$150 in deductions is not especially significant, and although any deduction mitigates progressivity, the progressive rates are not God-given. Reduction of marginal rates from 60% to 58% and from 20% to 19% through the use of personal exemptions might reach the right relative progression anyway.

⁹⁰ Orshansky, *Who Was Poor in 1966*, in *CHILDREN'S ALLOWANCES AND THE ECONOMIC WELFARE OF CHILDREN* 20-21 (E. Burns ed. 1968).

⁹¹ Dodyk, *supra* note 77, at 800.

⁹² Hickman points out that without all the tax changes since 1962, which include rate reductions in all brackets, the effective tax on all individuals would have risen from 10.6% to 14.7%, largely through inflation pushing income into higher brackets. Hickman, *supra* note 81.

As for the second point, although many preferences may exclude a greater amount from the tax base at the lower end of the income scale, the revenue foregone benefits those at the top. For example, the nontaxability of social security payments is justified on the ground that such payments are to the needy. But it is estimated that forty percent of the payments benefits people who would not otherwise be in want.⁹³ Including payments to the poor in the income base does not mean that they would be taxed, in view of deductions such as the low-income allowance or, possibly, a system of tax credits. Okner stresses that, accepting Hickman's limitation of realistic "loopholes" in the tax base as \$4.9 billion, nearly one-half the tax saved by those provisions goes to those with incomes over \$100,000—about three-tenths of one percent of the population.⁹⁴

The final set of statistics is somewhat misleading. First, the figures as to effective tax rates in various income brackets are apparently based on adjusted gross income, which is calculated only after such preferences as capital gains, percentage depletion, and accelerated depreciation on rental property.⁹⁵ Thus, if a taxpayer had \$1 million of long-term capital gain, he would be allowed to deduct \$500,000 in computing adjusted gross income. With no other income or deductions, his tax would be about \$320,000. This would be an effective rate of thirty-two percent if based on his actual income, but sixty-four percent of adjusted gross.

More basic, however, the appeal to average rates misses the entire point of tax reform. If two wage earners each have \$10,000 of income, but one pays no tax and the other pays \$6,000, their combined average rate is thirty percent. The premise, however, is that, absent a strong justification, people with equal income should pay equally.⁹⁶

The numbers cited by Hickman certainly do not demonstrate any bias in our present tax structure against people with capital. Under an income tax the ultimate competing interests, as recognized by McGovern's tax slogan,⁹⁷ are earnings and income from capital. The Nixon Administration has recently favored the latter through ADR, increased payroll taxes, and reenactment of the investment credit. ADR was originally adopted by the Treasury as an interpretation of existing

⁹³ See generally C. GREEN, *NEGATIVE TAXES AND THE POVERTY PROBLEM* 14-33 (1967).

⁹⁴ Letter from B. Okner to the N.Y. Times, May 8, 1972, at 36, col. 4.

⁹⁵ CODE § 62.

⁹⁶ As it was put by a Canadian Royal Commission on Taxation, recommending against favorable treatment of capital gains, "a buck is a buck is a buck." Quoted in E. BENSON, *PROPOSALS FOR TAX REFORM* 36 (1969).

⁹⁷ See text accompanying note 73 *supra*.

law.⁹⁸ This was criticized as the reenactment, by administrative action, of the legislatively repealed investment credit.⁹⁹ When in 1971 Congress both reinstated the investment credit and legislatively approved ADR, it in effect afforded a double investment credit. On the other hand, the Tax Reform Act of 1969 increased the maximum capital gains tax rate from twenty-five to thirty-six and one-half percent, and lowered the highest rate on earned income from seventy to fifty percent.¹⁰⁰ By those measures, plus a temporary suspension of the investment credit and increased deductions for low-income taxpayers (whose income is mostly earnings), the Nixon Administration has not significantly changed the existing balance. In this sense, Hickman's argument represents a sound statement of the conservative position: after all the recent tinkering, nothing fundamental has changed. But that argument cuts both ways. If the tax burden has been falling unfairly for years, then even more fundamental change is called for.

We live in a country in which the richest one percent of the population owns between twenty and thirty percent of individually-owned capital,¹⁰¹ and in which tax subsidies generally favor such capital. Income from stock market gains is more valued by our tax laws than the same amount of income from writing a book, flying a plane, or curing disease. We live in a country which finances a large part of its old age benefits by a regressive tax only on earnings, because people like members of the President's Task Force find that \$30 billion contribution to be of "symbolic" significance.¹⁰² It is therefore difficult to make a persuasive case that tax reform should radically increase the advantage of income from capital over earnings, and of those taxpayers with capital over those without it.

VII

TOWARDS A MORE REALISTIC PROGRAM

In order to achieve a broader income base while tax reform is a popular issue, the following steps are suggested:

1. *Bookkeeping.* Tax equity should be divorced from the question

⁹⁸ See Bittker, *Treasury Authority To Issue the Proposed "Asset Depreciation Range System" Regulations*, 49 TAXES 265, 272 (1971).

⁹⁹ See *id.* at 268.

¹⁰⁰ CODE §§ 1201, 1348.

¹⁰¹ Study by L. Upton and N. Lyons of the Cambridge Institute, cited in Wicker, *The Rich Get Richer, etc.*, N.Y. Times, June 29, 1972, at 39, col. 1.

¹⁰² TASK FORCE REPORT 69.

of whether funds should be given to nontaxpayers. Regardless of whether such benefits are in the form of direct grants or a negative income tax, many people are repelled by the entire concept. The purpose of a broader tax base should be clearly associated with reducing the income tax of people who do not get special tax subsidies. The Nixon Administration originally suggested VAT as a device to help property taxpayers. Relief from income tax should elicit even more support.

Although the reallocation aspect would be highlighted if the initial proposals failed to result in greater total tax collections, that does not seem practicable at present unless, as Ehrlichman suggested, an income tax rise is not necessary. In that event 1973 would be an ideal year for income tax reform, and the Nixon Administration could support it without fear of an increased deficit.

The *Brookings Study*, however, has estimated that under present programs there will be a \$17 billion annual budget deficit at full employment by 1974-1975, in the absence of tax increases,¹⁰³ and Paul Samuelson predicted that regardless of who won the election, Congress would legislate higher taxes in 1973.¹⁰⁴ Based partly on such testimony, the Joint Economic Committee concluded that "[t]he pretense that additional revenues will not be needed should be abandoned in favor of a constructive discussion of how these revenues can be obtained."¹⁰⁵ In that event, the best that can be done is to pose the reform question in terms of income tax rates or the income tax base. But tax reform would inspire more support if at some future date it could be shown to lower taxes rather than simply not to increase them, or to increase them less than otherwise.

2. *Rates.* Any proposal should therefore contain a specific lower rate schedule, even if promises of cuts in the lower brackets are largely tokens of intention. As McGovern proposed, the maximum rate should be lowered from its present seventy percent to about fifty percent for three reasons. First, too high a rate distorts economic decisions, favoring investments which produce little current income and providing greater incentive for tax shelters. Second, without a capital gains preference

¹⁰³ BROOKINGS STUDY 418-19. This forecast was based on the assumption of a 5% social security increase, rather than the more than 20% increase signed into law. The Brookings team now predicts a \$20-\$25 billion budget deficit at full employment in fiscal year 1975. See Rivlin, *Dear Voter Your Taxes Are Going Up (No Matter Who Wins on Tuesday)*, N.Y. Times, Nov. 5, 1972, § 6, at 35.

¹⁰⁴ Statement by P. Samuelson, Professor, MIT, at Hearings of the Joint Econ. Comm. on the Midyear Review of the Economy, 92d Cong., 2d Sess., reprinted in BNA DAILY EXECUTIVE REP., No. 146, July 27, 1972, at J-5.

¹⁰⁵ JOINT ECON. COMM., THE 1972 MIDYEAR REVIEW OF THE ECONOMY, 92d Cong., 2d Sess. 16 (1972).

sixty to seventy percent rates would be unrealistic. Such rates would prevent the newer and more dynamic capital accumulations more than they would affect those already in existence. Estate and gift taxation is both a more effective and a more appropriate method of reducing the unequal distribution of wealth, since people who have not made the money are generally thought to be less deserving. Third, the entire reform proposal loses much of its soak-the-rich aura. Psychologically, complaints of an increased burden are less persuasive when the maximum rate has been lowered, and the few who now pay sixty to seventy percent on a substantial portion of their income may support the changes. Practically, a soak-the-rich program is not feasible. President Kennedy was unable to get Congress to enact a tax on unrealized capital gains at death even when such a tax would be accompanied by a lowering of the capital gains rate from twenty-five to twenty-one percent.¹⁰⁶ Any program that suggests both taxation in full and also at death should reduce the maximum capital gains rate to not more than the present maximum rate on earned income. We are far from reordering our priorities to *favor* earnings over investment.

3. *Social Security.* The social security system could be made more progressive by allowing a credit against income tax for up to twenty-five or fifty dollars of payroll tax. This large and highly visible subsidy to earnings, while not offsetting even the recent increase in social security tax, would fund at least a fraction of benefits through the general income tax system without attacking the trust fund concept.¹⁰⁷

4. *Capital Gains.* The full amount of capital gain, whether short-term or long-term, should be included in income. Gain should be considered realized upon disposition of property by gift or bequest. Upon such a disposition, however, gain should be limited to the increase in value after the legislation is passed, and residences and certain household property should be excepted.

5. *State Taxes.* Except as a business expense, state taxes should not be deductible. In order to encourage state and local income taxes in lieu of property and sales taxes, there could be a credit against federal income taxes for up to twenty percent of such taxes. This would make those taxes truly progressive, since the amount of federal benefit would no longer depend upon one's tax bracket. To give the states time to conform, the change could be made gradually. Since the standard

¹⁰⁶ See *Hearings on H.R. 8363 Before the Senate Comm. on Fin.*, 88th Cong., 1st Sess. 49 (1963).

¹⁰⁷ Senator McGovern's economic program included a proposal that some new social security coverage be funded through general revenues. See *N.Y. Times*, Aug. 30, 1972, at 22, col. 4.

deduction is intended to be in lieu of several itemized deductions, including state taxes, it might be decreased.

6. *ADR and Investment Credit.* ADR should be repealed, and the investment credit should be used only to stimulate investment during slack periods.

7. *Charitable Contributions.* Deductions for charitable contributions should not exceed the cost of the contributed property.

8. *Minimum Tax on Preferences.* This provision should be repealed.

9. *Tax Expenditure Budget.* The reform proposal should repropose the bill passed by the Senate in 1971. One impetus to reform is to show taxpayers the benefits they are not getting; direct grants may then be evaluated by Congress with reference to tax subsidies, and vice versa.¹⁰⁸

10. *Congressional Campaign Financing.* A Congressional Election Campaign Fund, similar to that established last year for post-1972 presidential campaigns,¹⁰⁹ should be established. Such a fund, by allowing people to designate one dollar of their income tax liability for use by a candidate, decreases his reliance on large contributors.

The above program is limited to ten proposals; as Clemenceau said of the Fourteen Points, God needed only ten. Omitted are several questionable tax subsidies, such as those to the real estate industry, to the oil and gas industry, and to exporters, all of which the McGovern program focused on. But the changes are in preferences which apply most widely. If the man with \$1,000 of state income tax can be made to see that ending that particular deduction will help him, then meaningful tax reform will be possible. Moreover, repealing preferences which benefit many taxpayers will put increased pressure on those which help a limited few. Despite Samuelson's claim that this would be "political suicide," which it could be if announced in conjunction with an expanded poverty program, a poll ordered by the commission studying VAT indicated that forty percent of those questioned preferred a broader tax base as a way of substantially raising federal taxes, even if that included cutting deductions for charities and local taxes.¹¹⁰

¹⁰⁸ A President might not want authority to cut spending in excess of a specified ceiling, as President Nixon did, if the political choice was one between direct grants to the poor and such tax preferences as the oil depletion allowance.

¹⁰⁹ Act of Dec. 10, 1971, Pub. L. No. 92-178, tit. VIII, § 801, 85 Stat. 563.

¹¹⁰ N.Y. Times, May 21, 1972, § 1, at 34, col. 3. Of those polled, 34% favored VAT, 10% preferred higher income tax rates, and 16% had no opinion.

FUTURE POSSIBILITIES

The suggestions advanced here are incomplete in two respects: they do not include estate and gift taxation, nor are they intended to provide revenues to finance new spending programs. Estate and gift taxation has historically been more of a leveling than a revenue-raising measure, since the preferences involved are not generally defensible as incentives. The question is therefore its technical effectiveness rather than the more controversial issue of economic priorities. Moreover, the full effect of estate tax changes takes place over at least a generation. Accordingly, although these provisions should be substantially strengthened, specific recommendations should probably await a Treasury study.

The possibilities with regard to financing new social programs include termination of additional income tax preferences, reenactment of various repealed excise taxes,¹¹¹ diversion of the alcohol tax from—or terminating—the highway trust fund, some increased estate and gift revenues, temporary surcharges, increases in corporate tax rates, and even VAT. In the Scandinavian countries broad social benefit programs, coupled with adjustments to the personal income tax, are felt to “more than offset” any element of regressivity of VAT of more than fifteen percent.¹¹² Assuming progressive income and estate taxes, and increased public spending, it might then be reasonable to favor capital. But not now. What you don’t see does hurt you.

¹¹¹ The *Brookings Study* ruled out estate and gift taxes, excise taxes (on the grounds of regressiveness and political opposition), and increased payroll taxes as possible additional sources of federal revenue. *BROOKINGS STUDY* 428.

¹¹² Cohen, *Treasury Says European Experience with Value Added Tax Is Favorable*, 35 *J. TAXATION* 316, 316-17 (1971).